Public Finance

Chapter 5

Principles of Taxation

Prof. Mahmoud A. Touny

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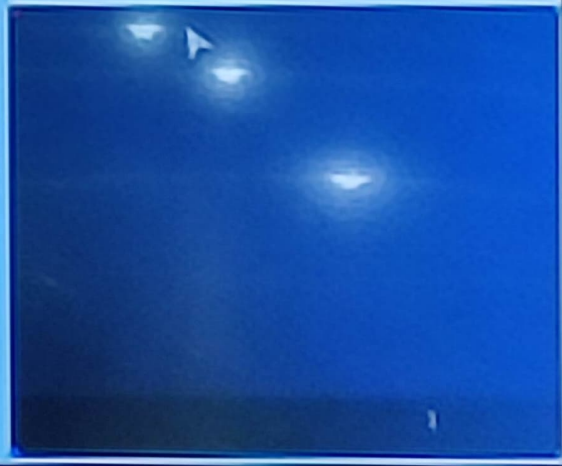

Introduction

- To support their expenditures, governments tax economic activity such as income-generating activities and consumption of goods and services.
- Although taxation is the main source of public revenue , governments obtain some funds from fees and charges.
- Governments also raise funds from enterprises they operate such as public utilities (water, gas, and electricity).

Introduction

- Governments may borrow funds when tax and non-tax revenues are insufficient to cover all their expenditures.
- This chapter begins with an exploration of the means and consequences of government finance.

What Are Taxes?

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- **"Tax is a compulsory financial obligation determined by the state and the taxpayer is obligated to pay it to finance government activities".**
- **First**, a tax is 'compulsory.' This means that the amount, the mode and time of levying, and the persons affected, are all determined by the authority.
- **Second**: The tax is an obligation determined by the state. the state imposes taxes, and determines its base, its price, and how and when it is collected.
- **Third**: The collected fund is used to finance different public expenditure programs.

Classification of taxes

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- We can classify taxes into three basic tax types; taxes on what you earn, taxes on what you buy, and taxes on what you own.
- Also, we can classify taxes as:
  - progressive, regressive, and proportional taxes;
  - direct and indirect taxes;
  - ad-valorem versus specific tax.

Taxes on what you earn:

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- ***Taxes on what you earn*** include individual income taxes, corporate income taxes, payroll taxes, and capital gains taxes.

➢ ***Individual Income Tax:***

- Is a tax on a person's income (wages, salaries, and other earnings from one's occupation; interest earned by savings accounts and certain types of bonds; rents).
- Each taxpayer must compute his or her tax liability and must send this information to the government.

➢ *Corporate Income Tax*

- All corporations in most countries must pay tax on their net income (profits) to the government.

➢ *Payroll Tax*

- payroll tax applies only to wages and salaries. Employers automatically withhold payroll taxes from employees' wages and forward them to the government.

➢ *Capital Gains Taxes*

- Capital gains are profits from the sale of stock, real estate, or other investments whose value has increased over time.

Taxes on what you buy:

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- It also called ***consumption taxes*** include, sales taxes, gross receipts taxes, value-added taxes, excise taxes, and tariffs.

➢ ***Sales taxes:***

- It's a form of consumption tax levied on retail sales of goods and services.
- Although sellers are legally responsible for paying sales taxes, the burden of any given sales tax is often divided between sellers and consumers.

➢ ***Gross receipts taxes:***

- Gross receipts taxes are applied to a company's gross sales, regardless of profitability and without deductions for business expenses.

➢ ***Value-Added Tax (VAT):***

- A Value-Added Tax (VAT) is a consumption tax assessed on the value added in each production stage of a good or service.

➢ ***Excise taxes:***

- Excise taxes also called ***selective sales taxes*** are taxes imposed on a specific good or activity such as tobacco products, alcoholic beverages, and gasoline.

➢ ***Tariffs:***

- Tariffs, also called ***customs duties***, are taxes levied on imported or exported goods.

Taxes on What You Own:

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- Taxes on What You Own include Property taxes, tangible personal property taxes, estate, and inheritance taxes, and wealth taxes.

➢ *Property taxes:*

- levied on immovable property like land and buildings.

➢ *Tangible personal property tax:*

- Tangible personal property is a property that can be moved or touched, such as business equipment, machinery, inventory, furniture, and automobiles.

➢ ***Estate and inheritance taxes:***

- Both estate and inheritance taxes are imposed on the value of an individual's property at the time of their death.
- While estate taxes are paid by the estate itself, before assets are distributed to heirs, inheritance taxes are paid by those who inherit property.

➢ ***Wealth taxes:***

- Wealth taxes are imposed annually on an individual's net wealth (total assets, minus any debts owed) above a certain amount.

Progressive, regressive, and proportional taxes:

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➢ *Progressive taxes:*

- A progressive tax is one in which, the rate of taxation increases as the tax base increases.
- The amount of tax payable is calculated by multiplying the tax base, with the tax rate.
- The taxes that are generally considered progressive include individual income taxes and estate taxes.

➢ ***Regressive taxes:***

- A regressive tax rate is one in which the rate of taxation decreases as the tax base increases.
- Taxes that are unrelated to the taxpayer's ability to pay are regressive.
- Sales taxes and excises (except those on luxuries) tend to be regressive.

➢ ***Proportional taxes:***

- A proportional tax system (also called a ***flat tax***) is one at which the rate of taxation remains constant as the tax base changes.

Direct and indirect taxes:

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➢ Direct taxes:

- Direct taxes are imposed by the state upon persons who are expected to bear the burden of these taxes and who are not expected to be able to shift the tax burden to other persons.
- Direct taxes are levied on the property and income of persons. Thus, income tax, wealth taxes, and land tax are called direct taxes.
- Direct taxes are progressive taxes. Thus, people with lower income pay lower taxes, and people with higher income pay higher taxes.

➢ *Indirect taxes:*

- Indirect taxes are taxes that are imposed upon persons, who are expected to shift the burden of the tax to other persons.
- Indirect taxes are usually imposed on consumption. Thus customs duties, excise taxes, sales taxes, and VAT are indirect taxes.
- Indirect taxes are widely known to be regressive in nature.
- One of the consequences of direct and indirect taxes is direct taxes can help address inflation while indirect taxes can lead to inflation.

Classification of taxes:

Direct and indirect taxes:

Context	Direct Tax	Indirect Tax
Imposed on	Income and profits	All the goods and services
Who pays	Individuals and businesses	End-consumers
How much	Depends on income and profits	Same for everyone
Transferability	Not transferable	Transferable
Tax Evasion	Possible	Not possible
Nature	Progressive	Regressive
Collections	Complex	Convenient
Common examples	Income tax	Sales taxes, VAT

Ad-valorem versus specific tax:

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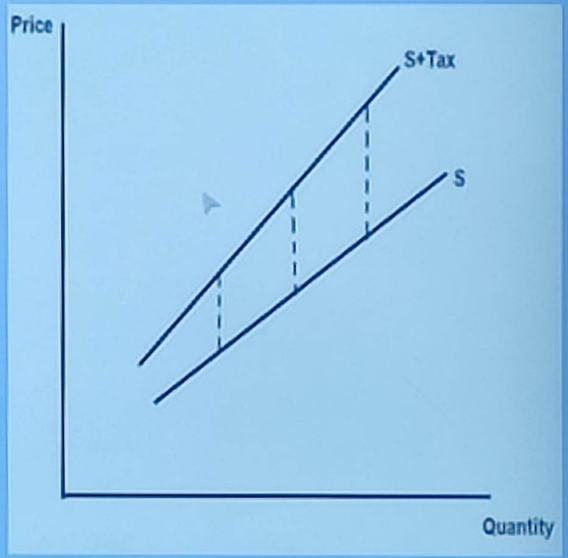
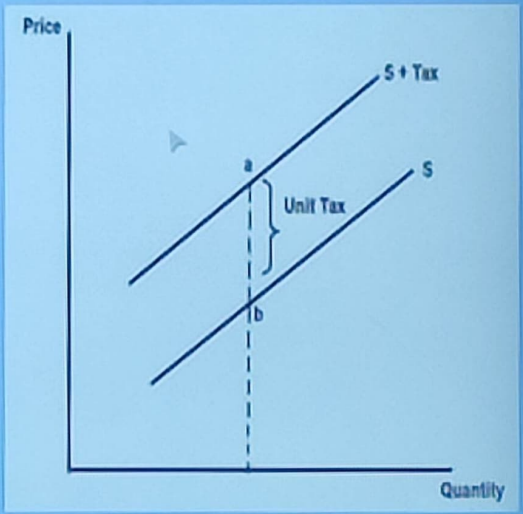
➢ ***Ad-valorem tax:***

- This tax is expressed as a percentage of the value of a commodity.
- In this case irrespective of the weight and size of the commodity, tax is charged according to its value.
- The imposition of an ad valorem tax will shift up the supply curve by a certain percentage, meaning that the new supply curve will not be parallel to the original.



➢ *Specific tax:*

- A specific tax is a fixed amount of tax placed on a particular good.
- It is also referred to as a per-unit tax, and the tax will depend on the quantity sold (not price).
- It may be also imposed according to the weight or the length of the commodity.
- A specific unit tax will shift up the supply curve by the full amount of the tax, so that the new curve is parallel to the original one.



Objectives of Taxation

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- In a market economy, taxes are imposed to provide funds to enable the government to undertake the following responsibilities:

➢ **Provision of Public Goods:**

The pure public goods have the following features:

1- The marginal cost of providing public good is equal to zero.

2- The exclusion principle cannot be applied

3- All members of society must consume the same amount of the public good.

- Since there is no compulsory payment for public goods, the government imposes taxes to finance the provision of public goods.

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